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DEPT OF TRANSPORTATION
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Lakes Pilots Association, Inc.
101 Water Street
P.O. Box 610902
Port Huron, MI 48061-0902

Docket Management Facility
(USCG-199-6098) -23
U.S. Department of Transportation Room
FL 401
400 Seventh Street SW
Washington, D.C. 20590-0001

October 27, 2000

TO WHO IT MAY CONCERN:

Enclosed you will find an attachment. This particular attachment is the speech that I gave at the Public Hearing of Proposed Rates that was held on October 12, 2000. Please carefully consider this information. I thank you in advance.

Sincerely,

Robert Frohm

Attachment

PROJECTION OF EXPENSES

The April 14, 2000 NPRM and the September 13, 2000 SNPRM utilized the following:

1. Projected Operating Expenses based on 1997 expenses.
2. Projected Revenue based on 1998 pilotage and detention revenue.
3. Target Pilot Compensation based on the 1999 American Maritime Officers Union contract.
4. Investment Base utilizing the 1997 net book value of the Association's fixed assets.

CFR REQUIREMENTS

46 CFR 404.1(B) states the following:

THE DIRECTOR SHALL REVIEW ASSOCIATION AUDIT REPORTS ANNUALLY AND, AT A MINIMUM, THE DIRECTOR SHALL COMPLETE A THOROUGH AUDIT OF PILOT ASSOCIATION EXPENSES AND ESTABLISH PILOTAGE RATES IN ACCORDANCE WITH THE PROCEDURES DETAILED IN SEC 404.10 OF THIS PART AT LEAST ONCE EVERY FIVE YEARS.

46 CFR 404.10 Appendix A - Step 1 states the following:

THE DIRECTOR PROJECTS THE AMOUNT OF VESSEL TRAFFIC ANNUALLY. BASED ON THAT PROJECTION, THE DIRECTOR FORECASTS THE AMOUNT OF FAIR AND REASONABLE OPERATING EXPENSES THAT PILOTAGE RATES SHOULD RECOVER. THIS CONSISTS OF THE FOLLOWING PHASES.

- (A) SUBMISSION OF FINANCIAL INFORMATION FROM EACH ASSOCIATION;
- (B) DETERMINATION OF RECOGNIZABLE EXPENSES;
- (C) ADJUSTMENT FOR INFLATION OR DEFLATION; AND
- (D) FINAL PROJECTION OF OPERATING EXPENSES.

The CFR clearly states that the ratemaking must be based on the financial information submitted by each Association annually. Nowhere in the CFR is the Director permitted to project expenses using the financial data from a variety of years. The CFR requires that the 2000 ratemaking be based on actual 1999 data.

COAST GUARD ACTION

The Director completed the following audits of District 2 during the past five years:

- a. 1995 audit completed during June, 1996.
- a. 1996 audit completed during August, 1997.
- b. 1997 audit completed during August, 1998.
- c. 1998 audit completed during October, 1999.
- d. 1999 audit completed during August, 2000.

The April 14, 2000 NPRM states the following:

Each year, the Director determines which Association expenses will be recognized for ratemaking purposes. The Director may hire an independent CPA firm to review the expenses reported by the Association using the guidelines contained in 46 CFR 404.05. However, for 1999 this was not possible due to the transfer of the Office of the Director, Great Lakes Pilotage from the St. Lawrence Seaway Development Corporation to the United States Coast Guard, and the fact that the position of Economist on the Director's staff was vacant for the last half of 1998. To determine the reasonable and necessary expenses for the purpose of the 1999 Rate Review, we used the Director's 1997 independent audit of the Associations.

The September 13, 2000 SNPRM states the following:

The preliminary fieldwork for the Director's 1998 audit of the Great Lakes Pilotage Districts was completed in mid-October, 1999. The preliminary draft of the final report was delivered to the Coast Guard mid-December, 1999. The 1999 Rate Review was finalized in August of 1999 and routed for review and clearance with the Coast Guard in mid-September, 1999.

The CFR only requires the Director to complete a thorough audit of Association expenses every five years. If the Director decides to complete an audit annually, the results of that audit must be available at the time of the rate review and considered along with the annual financial information submitted by the Associations. Clearly the intent of the CFR is that the Director have all relevant information before him at the time of the ratemaking. Nowhere in the CFR is the Director permitted to project information from a variety of years simply because the Director has not conducted the annual audit on a timely basis. The Associations would be expected to continue servicing their customers while relocating their offices. The Associations should not be penalized because of the Office of Great Lakes Pilotage's problems.

A computation of the 2000 rate, based on District 2's audited financial statements at December 31, 1999, is included with this response. This computation includes the disallowance, with which we do not agree, of the same expense items as proposed by the Director. The computation shows a rate increase of 1% as opposed to the 4% rate decrease proposed in the September 13, 2000 NPRM.

[Code of Federal Regulations]
 [Title 46, Volume 8, Parts 200 to 499]
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[Page 425]

TITLE 46--SHIPPING

DEPARTMENT OF TRANSPORTATION

PART 404--GREAT LAKES PILOTAGE RATEMAKING--Table of Contents

Sec. 404.1 General ratemaking provisions.

(a) The purpose of this part is to provide guidelines and procedures for Great Lakes pilotage ratemaking. Included in this part are explanations of the steps followed in developing a pilotage rate adjustment, the analysis used, and the guidelines followed in arriving at the pilotage rates contained in part 401 of this chapter.

(b) Great Lakes pilotage rates shall be reviewed annually in accordance with the procedures detailed in Appendix C to this part. The Director shall review Association audit reports annually and, at a minimum, the Director shall complete a thorough audit of pilot association expenses and establish pilotage rates in accordance with the procedures detailed in Sec. 404.10 of this part at least once every five years. An interested party or parties may also petition the Director for a review at any time. The petition must present a reasonable basis for concluding that a review may be warranted. If the Director determines, from the information contained in the petition, that the existing rates may no longer be reasonable, a full review of the pilotage rates will be conducted. If the full review shows that pilotage rates are within a reasonable range of their target, no adjustment to the rates will be initiated.

[50 FR 18370, Apr. 11, 1995, as amended at 61 FR 21084, May 9, 1996. Redesignated and amended at 61 FR 32655, June 25, 1996, and further redesignated and amended by USCG-1998-3976, 63 FR 35139, 35140, June 29, 1998]

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TITLE 46--SHIPPING

DEPARTMENT OF TRANSPORTATION

PART 404--GREAT LAKES PILOTAGE RATEMAKING--Table of Contents

Sec. 404.10 Ratemaking procedures and guidelines.

(a) Appendix A to this part is a description of the types of analyses performed and the methodology followed in the development of a case pilotage rate. Ratemaking calculations in appendix A of this part are made using the definitions and formulas contained in appendix B of this part. Appendix C of this part is a description of the methodology followed in the development of annual reviews to base pilotage rates. Pilotage rates actually implemented may vary from the results of the calculations in appendices A, B and C of this part, because of agreements with Canada requiring identical rates, or because of other circumstances to be determined by the Director. Additional analysis may also be performed as circumstances require. The guidelines contained in Sec. 404.05 are applied in the steps identified in appendix A to this part.

(b) A separate ratemaking calculation is made for each of the following U.S. pilotage areas:

Area 1--the St. Lawrence River;
Area 2--Lake Ontario;
Area 4--Lake Erie;
Area 5--the navigable waters from South East Shoal to Port Huron, MI;
Area 6--Lakes Huron and Michigan;
Area 7--the St. Mary's River; and
Area 8--Lake Superior.

[60 FR 18170, Apr. 11, 1995. Redesignated and amended at 61 FR 32655, June 25, 1996, and further redesignated and amended by USCG-1998-3976, 63 FR 35139, 35140, June 29, 1998]

Appendix A to Part 404--Ratemaking Analyses and Methodology

Step 1: Projection of Operating Expenses

(1) The Director projects the amount of vessel traffic annually. Based upon that projection, the Director forecasts the amount of fair and reasonable operating expenses that pilotage rates should recover. This consists of the following phases:

- (a) Submission of financial information from each Association;
- (b) determination of recognizable expenses;
- (c) adjustment for inflation or deflation; and
- (d) final projection of operating expenses. Each of these phases is detailed below.

Step 1.A.--Submission of Financial Information

(1) Each Association is responsible for providing detailed financial information to the Director, in accordance with part 403 of this chapter.

TABLE A.-DISTRICT 1

Methodology	Area 1 St. Lawrence River	Area 2 Lake Ontario	Total District 1
Step 1, Projection of operating expenses	\$287,152	\$244,612	\$531,764
Step 2, Projection of target pilot compensation	\$1,088,282	\$414,578	\$1,502,838
Step 3, Projection of revenue	\$1,333,991	\$687,207	\$2,021,188
Step 4, Calculation of investment base	\$0	\$0	\$0
Step 5, Determination of target return on investment	8.69%	6.69%	6.69%
Step 6, Adjustment determination	\$1,359,198	\$845,374	\$2,004,672
Step 7, Adjustment of pilotage rates	1.03	.96	1.01

TABLE B.-DISTRICT 2

Methodology	Area 4 Lake Erie	Area 5 South East Shoal to Port Huron Michigan	Total District 2
Step 1, Projection of operating expenses	\$609,164	\$518,917	\$1,128,081
Step 2, Projection of target pilot compensation	\$518,220	\$1,243,728	\$1,761,948
Step 3, Projection of revenue	\$1,156,057	\$1,008,198	\$3,042,255
Step 4, Calculation of investment base	\$45,397	\$71,008	\$116,403
Step 5, Determination of target return on investment	6.69%	6.69%	6.69%
Step 6, Adjustment determination	\$1,134,321	\$1,773,486	\$2,907,817
Step 7, Adjustment of pilotage rates	.98	.94	.96

TABLE C.—DISTRICT 3

Methodology	Area 6 Lakes Huron and Michigan	Area 7 St. Mary's River	Area 8 Lake Superior	Total District 3
Step 1, Projection of operating expenses	\$648,500	\$128,476	\$446,608	\$1,223,584
Step 2, Projection of target pilot compensation	\$1,140,084	\$621,864	\$829,152	\$2,591,100
Step 3, Projection of revenue	\$1,797,367	\$688,583	\$1,333,917	\$3,820,467
Step 4, Calculation of investment base	\$11,687	\$4,585	\$8,934	\$25,206
Step 5, Determination of target return on investment	8.69%	6.69%	6.69%	6.69%
Step 6, Adjustment determination	\$1,789,386	\$750,648	\$1,276,358	\$3,816,392
Step 7, Adjustment of pilotage rate	1.00	1.00	.95	.99

Here is a detailed explanation of our step-by-step calculations.

Step 1 A: Submission of Financial Information

Our first step is to gather financial data from each of the three Great Lakes pilot associations (the Associations). Each of the Associations must obtain an audit by an independent Certified Public Accountant (CPA) and submit these audits to the Director of the Great Lakes Pilotage (the Director), in accordance with 46 CFR 403.900.

Step 1 B: Determination of Recognizable Expenses

Each year, the Director determines which Association expenses will be recognized for ratemaking purposes. The Director may hire an independent CPA firm to review the expenses reported by the Association using the guidelines contained in 46 CFR 404.05. However, for 1999 this was not possible

due to the transfer of the Office of the Director, Great Lakes Pilotage from the St. Lawrence Seaway Development Corporation to the United States Coast Guard, and the fact that the position of Economist on the Director's staff was vacant for the last half of 1998. To determine the reasonable and necessary expenses for the purpose of the 1999 Rate Review, we used the Director's 1997 independent audit of the Associations. In the following

paragraphs, we discuss some of the details of the audit and afterward, we have provided you with a table containing the expenses that the Director recognized and approved.

We calculate target pilot compensation each year based on the previous year's compensation earned by first mates on U.S. Great Lakes vessels. That figure is added to the total expenses to determine the revenue needed for ratemaking purposes. District 2 reported pilot compensation of

\$245,649 as training expenses and District 3 reported applicant pilot salaries and benefits of \$274,509 as an expense. Because the figures represent pilot compensation, they cannot be considered expenses for ratemaking purposes. The Director subtracted these expenses from the expense bases of Districts 1 and 2.

To support safety and ongoing learning, each Pilot's Association agreed to develop a Continuing Education Plan for registered pilots to keep them aware of safety issues and refresh their skills. Each Association submitted a plan that the Director approved, with minor modifications. The Director will continue to monitor these plans to ensure they have been implemented, are effective and are applied to each District's continuing education account. The Director reserves the right to modify each plan as necessary.

In order to encourage safety and compensate each District for its training

based on projected bridge hours to provide a projection of total expenses for the District (Total Target Pilot Compensation + Projected Operating Expenses). This total is then compared to revenue projections based on projected bridge hours for the District to determine if the pilotage rates should be increased or decreased. Accounting for temporarily registered pilot compensation as a training expense inflates the District's expense base in that total pilot compensation is accounted for separately and then combined with operating expenses. This is evident in the fact that in 1998, pilots in District 2 exceeded their compensation targets by 16%.

Seven commenters, the three pilotage Districts or their respective representatives, the accounting firm for District 2, the American Pilots' Association, the Atlantic Coast District of the International Longshoremen's Association, and the Grand Lodge International Ship Masters' Association, all disagreed with the use of 1997 expense data and 1998 revenues to determine a pilotage rate for 1999. The lobbying firm representing District 1 further questioned the procedure because of its belief that 1998 expense data had been available to the Coast Guard for well over a year.

The preliminary fieldwork for the Director's 1998 audit of the Great Lakes Pilotage Districts was completed in mid October 1999. The preliminary draft of the final report was delivered to the Coast Guard mid December 1999. The 1999 Rate Review was finalized in August of 1999 and routed for review and clearance within the Coast Guard in mid September 1999. The 1999 Rate Review followed the methodology prescribed in Appendix A to 46 CFR Part 404. 1997 expenses for each of the pilotage Districts were projected forward to 1999 based on the actual change in traffic from 1997 to 1998 and the projected change in bridge hours or traffic for 1999, based on economic surveys. Economic surveys from industry and the St. Lawrence Seaway Development Corporation indicated that 1999 would experience an overall 5% reduction in bridge hours and traffic from 1998 levels. In 1998, the actual bridge hour data and revenues for 1998 in each of the pilotage areas became available to the Coast Guard in May 1999, through the submission of unqualified audited 1998 financial data by each of the District's Pilot associations, as required by 46 CFR § 403.300. A review of the financial data indicated that on average, revenues and bridge hours throughout the Great Lakes increased 30% in 1998 over 1997 levels.

The actual 1998 observed increase for each District was then combined with the projected 5% decrease in traffic for 1999 to establish an overall change in traffic from 1997 to 1999. For example, in 1998, District 1 experienced an average 36% increase in bridge hours over 1997. Considering the projected 5% reduction in 1999 from 1998 levels, this resulted in an overall projected increase of 31% in 1999 over 1997 levels ($36\% - 5\% = 31\%$) for District 1. For the 1999 rulemaking, each District's approved 1997 expenses were adjusted for inflation (Approved Expenses \times (1+Inflation Factor)) multiplied by the aggregate percentage change of traffic projected for each District over 1997 levels. We then factored in the percentage of Association expenses that change in relation to a change in traffic (pilotage hours). Analysis indicates that 57% of Association expenses are affected by a change in pilotage hours. For example, in District 1, pilotage hours for 1999 are projected to increase 31% over 1997 levels, which is multiplied by 57% ($.31 \times .57 = .18$) to project that District 1's operating expenses should increase 18% in response to the projected increase in pilotage hours for 1999 from 1997 levels. Therefore, the following formula was utilized to project 1999 expenses ((Approved 1997 expenses \times (1+Inflation Factor)) \times (1+(.31 \times .57))). In the case of District 1, in order to incorporate approved transportation and training costs into the rate, an additional \$86,000 was added to District 1's expense base for the 1999 rulemaking.

Two Commenters, the District 2 Pilots' Association and their accounting firm, requested an explanation of why and how their pilot boat expenses were reduced for the 1999 Rate Review. 46 CFR Part § 404.5 establishes the guidelines for the Director of Great Lakes Pilotage in determining whether expenses will be recognized in the rulemaking process. It specifies that each expense item be evaluated to determine whether it is necessary for the provision of pilotage service and if so, whether it is reasonable, that is, is it comparable or similar to the expenses paid by others in the maritime industry for the same service or item. Pilot boat expenses in District 2 average \$176 per trip, whereas in District 1, they average \$110 and in District 3 they average \$83 per trip. District 3 contracts all pilot boat services while Districts 1 and 2 utilize affiliated companies owned totally or partially by registered pilots, to provide pilot boat services. These affiliated companies reported a net income of \$4,520 in District 1 and

\$70,508 in District 2, in 1997. In District 2 Erie Leasing's net income of \$70,508 represents a 10% return on total equipment and property less land of \$372,270. To bring pilot boat expenses in line with Districts 1 and 3, the Director is reducing District 2's expense base by \$45,602. This deduction is intended to offset Erie Leasing's net income of \$70,508 from operations. This, in effect, reduces Erie Leasing's net income to \$24,904, which represents a 6.69% return on Erie Leasing's property and equipment. When this offset is applied against the 1997 pilot boat expenses, it reduces the pilot boat cost in District 2 to \$154 per trip.

Two commenters, the District 1 Pilots' Association and District 2's accounting firm, disagreed with the results of the computation that determined the number of pilots required for their respective Districts. In District 1 they disagreed with the number of pilots required in Area 2, Lake Ontario. 46 CFR Part 404 clearly establishes the methodology in determining the number of pilots required for each area: "The basis for the number of pilots needed in each area of undesignated water is established by dividing the projected bridge hours by 1800. In 1998, District 1 Lake Pilots recorded a total of 6,335 bridge hours on the undesignated waters of Lake Ontario. The 1999 Rate Review projected a 5% decrease resulting in a projection of 6,018 bridge hours for 1999. The number of pilots required is then determined by dividing 6,018 by 1800; the result is 3.34, which for the purposes of the 1999 Rate Review, was rounded up to 4 pilots. District 2's accounting firm disagreed with the standard of 1800 hours used to determine the number of pilots in undesignated waters, and included delay, detention and pilot travel hours together with bridge hours to calculate the number of pilots required in District 2. Again 46 CFR Part 404 established 1800 bridge hours (detention, delay, and travel hours are not included) as the work standard used to determine the number of pilots required on undesignated waters.

One commenter, the District 2 Pilots' Association, questioned the deduction of \$3,328 in "combined expenses." As explained in note 3 of the 1997 Director's audit, of \$3,328 incurred legal expenses, one half, \$1,664, was deducted because expenses relating to lobbying are not allowed for rulemaking purposes. 46 CFR, Part 404, § 404.5.

Two commenters, the District 2 Pilots' Association and District 2's accounting firm, disagreed with the deduction of daily subsistence amounts that did not conform to IRS guidelines. 46 CFR

Lakes Pilots Association, Inc.
Great Lakes Pilotage Rate Computation
2000 Methodology-1999 Financial Information

Step 1 - Projection of Operating Expense

Pilots salaries and expenses		\$	2,049,756.00
Less: Wages	\$	900,291.00	
Hospitalization insurance		125,555.00	
Disability insurance		4,462.00	
Group insurance		13,550.00	
Pension & profit sharing		304,031.00	(1,347,889.00)
			701,867.00
Pilot boat			303,283.00
General & administrative			401,908.00
Total operating expenses			1,407,058.00
Less: St. Lawrence Seaway Development Corporation adjustments:			
APA lobbying costs		9,120.00	
Business promotion		974.00	
Charitable contributions		100.00	
Workers compensation dividends		67,527.00	
Erie Leasing		52,559.00	
Pilot boat service revenue		100,899.00	
Dispatch service revenue		80,515.00	(311,694.00)
Less: Director's adjustments:			
Training expense		354,341.00	
Legal expense		19,027.00	
Continuing education expense		(40,000.00)	(333,368.00)
Total recognized operating expenses			761,996.00
Adjustment for inflation:			
Recognized expenses		761,996.00	
Inflation factor		3.10%	23,622.00
Adjustment for decrease in pilot hours			
Recognized expenses		785,618.00	
Factor		57.00%	
		447,802.00	
Decrease in pilot hours		-5.00%	(22,390.00)
Total projected operating expenses		\$	763,228.00

Lakes Pilots Association, Inc.
Great Lakes Pilotage Rate Computation
2000 Methodology-1999 Financial Information

Step 2 - Projection of Target Pilot Comp

Area 4

First mate compensation	\$	103,644.00	
Number of pilots required	x	5	\$ 518,220.00

Area 5

First mate comp times 1.5	\$	155,466.00	
Number of pilots required	x	8	1,243,728.00
		-----	-----
			\$ 1,761,948.00
Projected target pilot compensation			=====

Step 3 - Projection of Revenue

Per 12/31/99 financial statements		
Pilotage & detention	\$	2,546,274.00
		=====

Step 4 - Calculation of Investment Base	\$	483,770.00
-----		=====

Step 5 - Target Rate of Return on Investment

1999 average annual rate for new issues of high grade corporate securities as determined by the Market Finance Division of Department of Treasury		7.04%
		=====

Lakes Pilots Association, Inc.
Great Lakes Pilotage Rate Computation
2000 Methodology-1999 Financial Information

Step 6 - Adjustment Determination

Investment base - 1999 base	\$	483,770.00
Rate of return on investment		7.04%

Return element		34,057.00
Interest expense		(6,060.00)

Net Income	\$	27,997.00
		=====

After Adjustment		Total
-----		-----
Projected revenue	\$	2,569,233.00
Projected operating expenses		(763,228.00)
Projected target pilot compensation		(1,761,948.00)

Operating loss		44,057.00
Interest expense		(6,060.00)
Income tax		(10,000.00)

Net income	\$	27,997.00
		=====

Step 7 - Adjustment of Pilotage Rates

		Total

Revenue required - Step 6	\$	2,569,233.00
Projected Revenue - Step 3		2,546,274.00

		1.0090
		=====

LEASE EXPENSE - PORT COLBORNE FACILITY

The April 14, 2000 NPRM disallows \$4,800 of rent expense associated with a facility located at Port Colborne, Ontario.

CFR REQUIREMENTS

46 CFR 404.5 Paragraph 3 states the following:

LEASE COSTS FOR BOTH OPERATING AND CAPITAL LEASES ARE RECOGNIZED FOR RATEMAKING PURPOSES TO THE EXTENT THAT THEY CONFORM TO MARKET RATES. IN THE ABSENCE OF A COMPARABLE MARKET, LEASE COSTS ARE RECOGNIZED FOR RATEMAKING PURPOSES TO THE EXTENT THAT THEY CONFORM TO DEPRECIATION PLUS AN ALLOWANCE FOR RETURN ON INVESTMENT (COMPUTED AS IF THE ASSET HAD BEEN PURCHASED WITH EQUITY CAPITAL). THE PORTION OF LEASE COSTS THAT EXCEED THESE STANDARDS IS NOT RECOGNIZED FOR RATEMAKING PURPOSES.

COAST GUARD ACTION

The 1997 audit report issued by the Director's independent CPA states the following:

During our fieldwork we noted payments to Erie Leasing Inc., a company formed primarily to rent equipment and property to the Association. Included in this arrangement is a house in Port Colborne, Ontario rented for \$1,200 a month to the Association. Based on discussions with realtors in the area and a search of the internet, we found that the fair market value in an "arms length transaction" was not more than \$1,000 a month in Canadian dollars. While this house was used for temporary accommodations of pilots and the cost of individual motel rooms would be much higher, an adjustment of \$400 a month or \$4,800 annually would be called for to adjust for the economic fair market value of this transaction.

The September 13, 2000 SNPRM states the following:

One commenter, District 2's accounting firm, disagreed with the independent auditor's reduction of \$4,800 a year in total rental expenses for a six bedroom house rented to the Pilots Association by Erie Leasing, an affiliated company. The house is used as temporary accommodations in Port Colborne. The auditor's adjustment is based on the fact that similar accommodations in the area rent an average \$400 a month less than the Association pays on a monthly basis.

The Director indicates that market rates were established only by calls to realtors and research on the Internet. The Director has never produced any of this research or proved to what extent this research considered property comparable to the Port Colborne facility.

The rental house at Port Colborne is not what one would call a "standard" house. The facility contains six bedrooms, six bathrooms, phones in each individual room, and a radio to monitor all ships in the Welland Canal. The facility also includes a chart room with up-to-date charts and publications where agents, users and fellow pilots can call and get accurate answers to their questions. This room, in particular, is a great safety tool.

The facility is used by fourteen pilots and numerous drivers. It is located just minutes from stores, restaurants and the pilot boat station where the pilots board their next assigned vessel. The facility gives the pilot a familiar place to rest before taking his next assignment.

The current cost of leasing this temporary accommodation is \$1,300 per month or \$15,600 annually. The cost of a motel room for the 415 nights which the pilots and drivers use the facility results in an annual savings of \$21,580 (based on \$52.00 per night). When 831 one-way taxi trips (based on \$10.00 per trip) for the pilots are added to the motel cost, the combined cost is \$29,890. The annual savings totals \$14,290.

On August 8, 2000, Mr. Tom Lawler, Chief Economist, Great Lakes Pilotage, and his independent auditor both acknowledged to District 2's staff that they now realized what a great savings the Port Colborne facility is and they were going to approve the rent payments in full for the 1999 audit. The rental payments should also be allowed in full for the 2000 ratemaking. If District 2 did not lease the Port Colborne facility, the District would incur nearly \$30,000 in motel and taxi costs. District 2 should not be penalized for developing a cost efficient means of providing temporary housing for its pilots and drivers.

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TITLE 46--SHIPPING

DEPARTMENT OF TRANSPORTATION

PART 404--GREAT LAKES PILOTAGE RATEMAKING--Table of Contents

Sec. 404.5 Guidelines for the recognition of expenses.

(a) The following is a listing of the principal guidelines followed by the Director when determining whether expenses will be recognized in the ratemaking process:

(1) Each expense item included in the rate base is evaluated to determine if it is necessary for the provision of pilotage service, and if so, what dollar amount is reasonable for that expense item. Each Association is responsible for providing the Director with sufficient information to show the reasonableness of all expense items. The Director will give the Association the opportunity to defend any expenses that are questioned. However, subject to the terms and conditions contained in other provisions of this part, expense items that the Director determines are not reasonable and necessary for the provision of pilotage services will not be recognized for ratemaking purposes.

(2) In determining reasonableness, each expense item is measured against one or more of the following:

(i) Comparable or similar expenses paid by others in the maritime industry,

(ii) Comparable or similar expenses paid by other industries, or

(iii) U.S. Internal Revenue Service guidelines.

(3) Lease costs for both operating and capital leases are recognized for ratemaking purposes to the extent that they conform to market rates. In the absence of a comparable market, lease costs are recognized for ratemaking purposes to the extent that they conform to depreciation plus an allowance for return on investment (computed as if the asset had been purchased with equity capital). The portion of lease costs that exceed these standards is not recognized for ratemaking purposes.

(4) For each Association, a market-equivalent return-on-investment is allowed for the net capital invested in the Association by its members. Assets subject to return on investment provisions are subject to reasonableness provisions. If an asset or other investment is not necessary for the provision of pilotage services, the return element is not allowed for ratemaking purposes.

(5) For ratemaking purposes, the revenues and expenses generated from Association transactions that are not directly related to the provision of pilotage services are included in ratemaking calculations as long as the revenues exceed the expenses from these transactions. For non-pilotage transactions that result in a net financial loss for the Association, the amount of

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the loss is not recognized for ratemaking purposes. The Director reviews non-pilotage activities to determine if any adversely impact the provision of pilotage service, and may make ratemaking adjustments or take other steps to ensure the provision of pilotage service.

(6) Medical, pension, and other benefits paid to pilots, or for the

Lakes Pilots Association
Notes to Financial Analysis

31, December 1997

1 BACKGROUND AND ORGANIZATION

Under the Great Lakes Pilotage Act of 1960 (Public Law 86-555), foreign vessels that operate in certain "designated waters within the Great Lakes and Lakes Pilots System are Required to take on board, and be directed, by a registered pilot." The Great Lakes encompasses Lake Superior, Michigan, Huron, Erie and Ontario. By mutual agreement by the United States and Canada, these pilotage services alternate between the two countries. The Pilotage Act vests the Secretary of Transportation with the responsibility for setting pilotage rates, based upon Projected traffic, the target pilot compensation and anticipated pilotage expenses which will be needed to serve this traffic.

Three districts have been established for the waters of the Great Lakes and each association of pilots has an exclusive license to provide the pilotage services within each district. The Lakes Pilots Association, Inc. provides the services in District 2 covering the Lake Erie and the Detroit and St. Claire Rivers.

On December 11, 1995, the Secretary of Transportation transferred responsibility for administration of the Great Lakes Pilotage Act from the Commandant of the Coast Guard to the Administrator of the St. Lawrence Seaway Development Corporation (SLSDC). Among the responsibilities transferred was the setting of Great Lakes pilotage rates. Two of the pilots districts filed suit and eventually prevailed on appeal to have this decision reversed and responsibility was restored to the United States Coast Guard.

2 RENT EXPENSE

During our field work we noted payments to Erie Leasing, Inc., a company formed primarily to rent equipment and property to the association. Included in this arrangement is a house in Port Colborne, Ontario rented for \$ 1,200 a month to the association. Based on discussions with realtors in the area and a search of the internet we found that the fair market value in an "arms length transaction" was not more than \$ 1,000 a month in Canadian dollars. While this house was used for temporary accommodations of pilots and the cost of individual motel rooms would be much higher an adjustment of \$ 400 a month or \$ 4,800 annually would be called for to adjust for the economic fair market value of this transaction.

3 LEGAL/LOBBYING EXPENSES

The association incurred incurred \$3,328 in legal expenses relating to meetings and discussions by their lawyers with their Congressman. Per regulation 407.05-8 lobbying expenses are not allowed for rate making purposes. Our adjustment of \$1,664 is one half the cost of the of the legal expenses associated with these meetings and discussions.

4 AMERICAN PILOTS ASSOCIATION DUES

Our examination of the associations annual audited financial statements noted APA dues in the amount of \$10,560. This amount includes \$1,584 paid for lobbying which, in accordance with regulation 33 CFR 407.05-8, is not allowed for rate making purposes. Our adjustment consists of dues associated with lobbying.

5 REIMBURSED PILOT BOAT AND DISPATCHING SERVICES

During the year the Corporation received and reported revenue from the Western Great Lakes Pilots Association (District 3) and the Canadian Great Lakes Pilots Association totaling \$ 137,020. This amount is comprised of pilot boat revenue of \$ 77,570 and dispatch service revenue of \$ 59,450. These reimbursements are adjusted out of the expenses as a reduction in costs for rate making.

§ 404.5 establishes IRS guidelines (IRS publication 17 "Your Federal Income Tax") as one of the tests used to determine the reasonableness of an expense. A copy of IRS publication 17 can be obtained by contacting the IRS at 1-800-829-1040, or by visiting their Web Site at www.irs.gov or www.irs.ustreas.gov.

One commenter, District 2, requested a copy of the 1997 audit. A copy of the 1997 Director's Audit was mailed to District 2 in June 1999. A copy of the Director's audit is also included as part of the docket supporting this rulemaking (USCC-1999-6098).

One commenter, District 2's accounting firm, disagreed with the independent auditor's reduction from the expense base of \$947 for business promotion, \$400 in contributions, and \$1,988 as uniforms expense. These deductions are justified because these expenses are not directly related to the provision of pilotage (46 CFR § 404.5).

One commenter, District 2's accounting firm, disagreed with the independent auditor's reduction of \$4,800 a year in total rental expenses for a six bedroom house, rented to the Pilots' Association by Erie Leasing, an affiliated company. The house is used as temporary accommodations in Port Colborn. The auditor's adjustment is based on the fact that similar accommodations in the area rent on average \$400 a month less than the Association pays on a monthly basis.

One commenter, the District 2 Pilots' Association, disagreed with the independent auditor's reduction of a portion of the expenses related to Association dues paid to the American Pilots' Association. This deduction is justified because the reduction consists of dues associated with lobbying. Expenses related to lobbying are not recognized for ratemaking purposes (46 CFR § 404.5).

One commenter, the representative for the District 1 Pilots' Association, disagreed with the proposed amount of \$45,000 budgeted for car service and recommended \$56,000. The recommendation is valid and District 1's expense base is adjusted accordingly to

reflect an expected car service expense of \$56,000.

One commenter, the representative for the District 1 Pilots' Association, disagreed with the projected 2.8% decrease in operating expenses for the 1999 navigational season in Area 2, considering the 23% increase in bridge hours experienced from 1997 to 1998. This 2.8% decrease is consistent with the data, because the number of pilots authorized in Area 2 in 1997 was in excess of what was required to operate efficiently in the area. In both 1997 and 1998, five pilots were authorized in Area 2. In 1997 and 1998, the actual bridge hours worked in Area 2 were 4,580 and 5,335 hours respectively. The methodology for determining the number of pilots required, as explained in 46 CFR Part 404, results in a requirement of 2.6 or 3 pilots in 1997, and 3.5 or 4 pilots in 1998. Based on bridge hour projections for 1999, the 1999 Rate Review calculated that four pilots are required in Area 2. This equates to a reduction of approximately \$103,544 in pilot compensation, thus a reduction in expenses or total revenue required for Area 2.

Two commenters, the District 2 Pilots' Association accounting firm and the District 3 Pilots' Association, disagreed with the use of the 2.1% inflation factor used in the calculations for the 1999 Rate Review, as the figure failed to account for inflation experienced during the 1999 navigational season. Upon further review, the Coast Guard agrees with the commenter and has adjusted the expense base of each of the Pilotage Districts to reflect the change in the Consumer Price Index from the close of the 1997 season to December 1999. This equates to a 3.1% inflation factor.

Two commenters, the District 2 and District 3 Pilots' Associations, disagreed with the Coast Guard's calculation of Investment Base for Return on Investment purposes, stating that it should take into account all assets employed in support of pilotage operations. One commenter stated the rate of return should be annualized, since the rates were last adjusted in 1997. In calculating the rate of return

the Coast Guard only considers property and equipment, because cash assets held on deposit earn interest. Inclusion of cash assets would encourage Pilot Associations to unnecessarily inflate their Investment Base and provide an additional source of return not available to other private businesses. Analysis of pilot associations' Investment Base indicated that since the concept of Return on Investment was introduced into the ratemaking methodology, Districts 2 and 3 greatly increased their Investment Base. In District 2, the Investment Base rose from \$265,488 in 1995 to \$413,998 in 1998, of which only \$116,041 was property and equipment. In District 3, the Investment Base soared from \$119,823 in 1995 to \$964,896 in 1998, and only \$25,583 was property and equipment. The Coast Guard factored Return on Investment (ROI) into each of its Rate Reviews since the rates were last set in 1997. The 1998 Review considered the appropriate ROI and calculated that rates should be lowered an average of 3%. The 1999 Rate Review utilized a 6.69% ROI to determine rates. However, in view of the fact that the 1999 rates will apply for a portion of the 2000 navigational season, the ROI for the 1999 Rate Review has been adjusted to reflect the 1999 average return on high grade corporate bonds of 7.04%. The expense base for each District will be adjusted accordingly for the purposes of this SNPRM.

One commenter, the District 2 accounting firm, commented on the fact that the Coast Guard did not reply to their comments on the 1998 Rate Review. Responses to all comments received on the 1998 Rate Review were drafted. They were not published because the Coast Guard determined that the 1997 rates fell within an acceptable range and decided not to change the rates, even though the 1998 Rate Review called for an average reduction in rates of 3%.

Summary of Proposed Changes

The changes discussed above are summarized in Tables A, B, and C below.

TABLE A.—DISTRICT 1

Methodology	Area 1 St. Lawrence River	Area 2 Lake Ontario	Total District 1
Step 1. Projection of operating expenses	\$298,527	\$252,587	\$549,113
Step 2. Projection of target pilot compensation	1,068,252	414,576	1,502,828
Step 3. Projection of revenue	1,333,991	687,207	2,021,198
Step 4. Calculation of investment base	0	0	0
Step 5. Determination of target return on investment	7.04%	7.04%	7.04%
Step 6. Adjustment determination	1,364,789	687,173	2,051,961

PROMOTION, DONATIONS, AND UNIFORMS

The April 14, 2000 NPRM totally disallows business promotion expense of \$947, contributions of \$400 and uniform expense of \$1,988 as being unrelated to the provision of pilotage services.

CFR REQUIREMENTS

46 CFR 405.5(a) Paragraph 2 states:

IN DETERMINING REASONABLENESS, EACH EXPENSE ITEM IS MEASURED AGAINST ONE OR MORE OF THE FOLLOWING:

- (1) COMPARABLE OR SIMILAR EXPENSES PAID BY OTHERS IN THE MARITIME INDUSTRY.
- (2) COMPARABLE OR SIMILAR EXPENSES PAID BY OTHER INDUSTRIES, OR
- (3) U.S. INTERNAL REVENUE SERVICE GUIDELINES.

COAST GUARD ACTION

The April 14, 2000 NPRM states the following:

In addition to the costs associated with legal expenses, the independent CPA firm also recommended additional deductions from District 2's expenses . . . \$947 for business promotion, \$400 in donations and \$1,988 for uniforms. None of these charges are necessary for the provision of pilotage services. The Director agrees with the independent CPA firms's findings and these expenses have been deducted from the rate base.

The September 13, 2000 SNPRM states the following:

One commenter, District 2's accounting firm, disagreed with the independent auditors reduction from the expense base of \$947 from business promotion, \$400 in contributions and \$1,988 as uniforms expense. These deductions are justified because these expenses are not directly related to the provision of pilotage (46 CFR 404.5).

Business promotion expense of \$947 was disallowed as unrelated to the provision of pilotage services. District 2 provides pilot boat services to lakers. Our revenue from servicing lakers was \$6,163.00. District 2 advertises and promotes this service as a means of generating revenue to offset total pilot boat expense. This revenue from outside sources reduces costs for all parties involved. This is a reasonable and necessary business expense.

Contributions in the amount of \$400 was disallowed as unrelated to the provision of pilotage services. These contributions are made to fundraising events by local sheriff and police associations which patrol the waters wherein the Association operates. This is necessary community goodwill.

Uniform expense in the amount of \$1,988 had been disallowed as unrelated to the provision of pilotage services. District 2 has adopted a standard uniform which designates the pilot as a readily identifiable member of Lakes Pilots Association, Inc. The pilots deal with foreign ship operators who do not speak the English language and the uniform identifies them as a pilot. In addition the pilots come into contact with Immigration, Customs, and Coast Guard personnel, as well as dock workers and gate security guards, all of whom identify the pilots by their distinctive uniforms. Often the pilots embark/disembark during the night. The uniforms represent a measure of safety for the pilots in that the uniforms provide immediate identification when pilots approach dock security in the dark. District 2's automobiles also have identifying emblems on the car doors. Uniforms are a reasonable and necessary cost of providing pilotage service on the Great Lakes.

District 2 has responded to the disallowance of these expenses with every audit that the Director has commissioned. District 2 has repeatedly tried to show that these expenses are reasonable and necessary to the provision of pilotage services. Why would an organization of professional, intelligent and educated pilots incur unnecessary expenses to the detriment of their paycheck? Unnecessary expenses reduce the ability of the pilots to achieve target pilot compensation. These expenses clearly meet the above criteria for recognition as defined by the CFR. Once again, the Director has not provided any specific reasons as to why these expenses are not allowable.

[Code of Federal Regulations]
[Title 46, Volume 8, Parts 200 to 499]
[Revised as of October 1, 1999]
From the U.S. Government Printing Office via GPO Access
[CITE: 46CFR404.5]

[Page 425-426]

TITLE 46--SHIPPING

DEPARTMENT OF TRANSPORTATION

PART 404--GREAT LAKES PILOTAGE RATEMAKING--Table of Contents

Sec. 404.5 Guidelines for the recognition of expenses.

(a) The following is a listing of the principal guidelines followed by the Director when determining whether expenses will be recognized in the ratemaking process:

(1) Each expense item included in the rate base is evaluated to determine if it is necessary for the provision of pilotage service, and if so, what dollar amount is reasonable for that expense item. Each Association is responsible for providing the Director with sufficient information to show the reasonableness of all expense items. The Director will give the Association the opportunity to defend any expenses that are questioned. However, subject to the terms and conditions contained in other provisions of this part, expense items that the Director determines are not reasonable and necessary for the provision of pilotage services will not be recognized for ratemaking purposes.

(2) In determining reasonableness, each expense item is measured against one or more of the following:

(i) Comparable or similar expenses paid by others in the maritime industry,

(ii) Comparable or similar expenses paid by other industries, or

(iii) U.S. Internal Revenue Service guidelines.

(3) Lease costs for both operating and capital leases are recognized for ratemaking purposes to the extent that they conform to market rates. In the absence of a comparable market, lease costs are recognized for ratemaking purposes to the extent that they conform to depreciation plus an allowance for return on investment (computed as if the asset had been purchased with equity capital). The portion of lease costs that exceed these standards is not recognized for ratemaking purposes.

(4) For each Association, a market-equivalent return-on-investment is allowed for the net capital invested in the Association by its members. Assets subject to return on investment provisions are subject to reasonableness provisions. If an asset or other investment is not necessary for the provision of pilotage services, the return element is not allowed for ratemaking purposes.

(5) For ratemaking purposes, the revenues and expenses generated from Association transactions that are not directly related to the provision of pilotage services are included in ratemaking calculations as long as the revenues exceed the expenses from these transactions. For non-pilotage transactions that result in a net financial loss for the Association, the amount of

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the loss is not recognized for ratemaking purposes. The Director reviews non-pilotage activities to determine if any adversely impact the provision of pilotage service, and may make ratemaking adjustments or take other steps to ensure the provision of pilotage service.

(6) Medical, pension, and other benefits paid to pilots, or for the

discernable effect on the actual provision of pilotage services. Therefore, we are disallowing these legal costs for the purposes of this ruling (\$10,900 in District 1, \$5,869 in District 3).

Furthermore, the Director believes that a major portion of the remaining legal costs, even after disallowance for the above, are still excessive. In 1997, District 1 reported \$34,138 in legal expenses, District 2: \$21,151, and District 3: \$58,203. The Director intends to recognize only those legal expenses that are reasonable, necessary and directly related to the provision of pilotage services (i.e., they directly result from a legal action). In 1997, District 1 incurred \$34,138 in legal expenses; \$1,244 of which was directly related to litigation. Therefore, in the absence of any documentation to justify these legal expenses, the Director, for rulemaking purposes, is disallowing \$2,894 in legal expenses for District 1. Furthermore, because there were no legal expenses related to litigation in Districts 2 and 3, the Director is disallowing \$21,151 for District 2 and \$58,203 for District 3.

In addition to the costs associated with the legal expenses, the independent CPA firm also recommended additional deductions from District 2's expenses in the amount of \$4800 for overpayment of dues, \$947 for business promotion, \$400 for donations, and \$1,988 for uniforms. None of these charges are necessary for the provision of pilotage services. The Director agrees with the independent

CPA firm's findings and these expenses have been deducted from the rate base.

(4) Expenses Related to Lobbying

The independent CPA firm recommended that we deduct \$1,392 from District 1, \$3,428 from District 2, and \$12,495 from District 3 for lobbying expenses including dues, legal charges, employee payrolls, and travel.

(5) Expenses Not Conforming to IRS Guidelines

The independent CPA firm recommended that we deduct \$2,484 from District 2's expense base for overpayment of a subsistence allowance that does not conform to IRS guidelines. The Director agrees with these findings and we deducted these expenses from the rate base.

During the 1999 navigational season, the Director initiated a change to District 1's Working Rules, in order to reduce pilot fatigue. This change increased the pilot's minimum time between assignments from eleven hours to thirteen hours and approved the use of a car service between home and pilot change points. During 1999, the cost of the car service was applied as a surcharge on the pilot's uniform source form. To incorporate this expense in District 1's expense base, the Director has approved an additional \$45,000.

Step 1.C: Adjustment for Inflation or Deflation

To adjust expenses for inflation, we increased the total recognized expenses for each association by 2.1%. The 2.1% inflation figure is based on the change

in the Consumer Price Index (CPI) from January 1998 to April 1999.

Step 1.D: Projection of Operating Expenses

Once all adjustments are made to the recognized operating expenses, the Director projects these expenses for each pilotage area. The Director considers foreseeable circumstances that could affect the accuracy of the projection and, as best as possible, determines the "projection of operating expenses."

For this rulemaking, we adjusted association expenses by multiplying the pilotage hour projection for each district (described in step 2.B., below) by the aggregate percentage of Association expenses that change in relation to a change in pilotage hours. Analysis indicates about 57% of Association expenses are affected by a change in pilotage hours. For instance, in District 1, pilotage hours are projected to decrease 5% (see step 2.B., below) which is multiplied by 57% to project that District 1's operating expenses should decrease 2.8% in response to the projected decrease in pilotage hours. Then, District-wide expenses were apportioned to each area according to the number of pilots in that area, as determined in step 2.B., below. For instance, District 1 is calculated to need seven pilots in Area 1 and four pilots in Area 2, therefore, Area 1 was assigned 64% of the expenses for the District and Area 2 was assigned 36% of the expenses for the District. The results of Step 1 for each district are displayed below.

DISTRICT 1

Methodology	Area 1 St. Lawrence River	Area 2 Lake Ontario	Total District 1
Projection of operating expenses	\$287,152	\$244,612	\$531,764

DISTRICT 2

Methodology	Area 4 Lake Erie	Area 5 South East Shoal to Port Huron MI	Total District 2
Projection of operating expenses	\$609,184	\$518,917	1,128,081

DISTRICT 3

Methodology	Area 6 Lakes Huron and Michigan	Area 7 St. Mary's River	Area 8 Lake Superior	Total District 3
Projection of operating expenses	\$648,600	\$128,475	\$446,603	\$1,223,580

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TABLE A.—DISTRICT 1

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Step 1. Projection of operating expenses	\$296,527	\$252,597	\$549,123
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Step 3. Projection of revenue	1,333,991	687,207	2,021,198
Step 4. Calculation of investment base	0	0	0
Step 5. Determination of target return on investment	7.04%	7.04%	7.04%
Step 6. Adjustment determination	1,384,789	687,173	2,051,951